Context To The US ISM-Manufacturing Disappointment

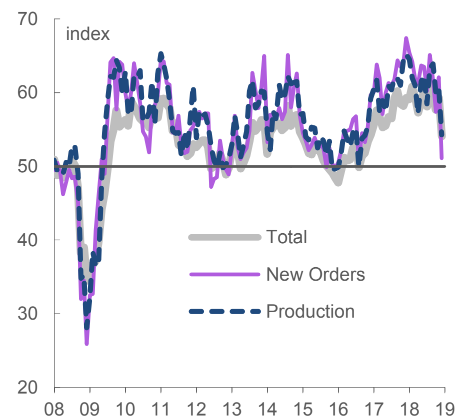
ISM manufacturing, December:
Actual: 54.1
Scotia: 58.2
Consensus: 57.5
Prior: 59.3

- Overall this is a dovish report but I'll come back to reinforcing the context into which it should be placed after assessing the details.
- The headline reading still signals moderate growth, but at a cooler pace than expected. 54.1 on the headline is no recession folks. Indeed, one could keep digging and on its own a much worse ISM header still wouldn't necessarily signal recession. Recall that ISM dipped into contraction territory at 47.8 back in early 2016 and recession did not ensue; all that was left in the aftermath was hysteria and opportunity.
- The details were broadly softer. **The new orders subcomponent is barely growing after falling 11 points to 51.1 and hence only a little above the 50 dividing line on expansion versus contraction.** How much of this is just the unwind of the surge over prior months to front-run tariffs? There might have been some of that, but **the main weakness in the order book came from domestic orders.** We can infer that from the reasonably stable new export orders book that, at 52.8, is comfortably within the same 52-handled range of the past three months.
- **The employment subcomponent also slipped to 56.2**, down 2.2 points but it is still signalling moderate employment gains.
- **Prices paid also decelerated** to 54.9 from 60.7. That still signals rising prices, but at a slowing pace. That's not terribly surprising as it reflects price signals in, say, commodities and particularly energy markets. **Hence there is rarely much new information offered by this component.**
- Now back to the context. **Are we sliding into recession, or simply resetting baselines?** Time will tell but I still subscribe to the latter. I think the dominant narrative is that we're just seeing the US economy coming off the stimulus-driven acceleration over the year that carried transitory effects. The TCJA and the US$300 billion February spending bill (half of which went out quickly through defense spending) including anticipatory effects were classic pump priming ahead of the November mid-terms. Many of the effects were transitory in terms of growth brought forward and that's the main thematic issue overhanging the debate over what is behind the growth slow down now. I don't see recession conditions whether we're talking very strong consumer finances, a zero real fed funds rate that has never been followed by recession at such depths, a flat but too distorted to be useful yield curve, and corporate financial conditions that are removing excess versus flagging recession risk in my opinion. I see the US economy just coming off of the effects of many other politicians ages before Trump have done over and over before elections. Deficits were used to buy votes and fill the swamp with Treasury notes and now this effect is maturing.
- It is also conceivable that broad dollar strength—basically tied with prior highs in late 2016 and early 2002—is damaging export competitiveness. Indeed,

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

US ISM Manufacturing



Sources: Scotiabank Economics, ISM.

note that the earlier reference to the sub-50 ISM reading in early 2016 coincided with the fourth highest level of the USD since the 1990s before the dollar then weakened ahead of going on another upward tear in the wake of the US election results in November 2016.

- It is also of course conceivable that tariffs are playing a role here. Indeed, many respondents specifically flagged tariff concerns as a reason to be more cautious. Message from businesses to Trump: lay off, and get a deal with China. My view remains that the US-China trade tensions will probably settle in much the same way as the CUSMA/USMCA and KORUS deals that involved little by way of ultimate concessions after a great deal of poisoned rhetoric. Again, time will tell.
- Markets are struggling with the price signals through this period, but the argument that such stimulus effects would be purely transitory with little/no lasting benefit to growth has been around throughout it all. I honestly think stocks just didn't pay enough attention to what was driving fundamentals and earnings through the stimulus period and hence didn't think through to the other side, so everything temporarily overshot where it should have ultimately gone. Now if the US can settle on a deal with China, and if that also lessens market appetite for safehavens like the USD, then much of this tempest could blow over as the year unfolds. Within the many 'ifs' are opportunities for both short-term minded institutional investors and longer term patient money.